



**DEFENSE CONTRACT AUDIT AGENCY**  
**DEPARTMENT OF DEFENSE**  
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IN REPLY REFER TO

PAC 730.31/2002-17

October 23, 2002  
02-PAC-079(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA  
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Determination of Government Share of Income Tax Refunds

**Summary**

Auditors should determine the government's share of income tax refunds based on the government's original reimbursement of that expense. The government is entitled to share in the income tax refund on contracts containing contract clause FAR 52.216-7, Allowable Cost and Payment.

**Background**

In Hercules Inc. v. United States, 292 F.3d 1378 (Fed. Cir. 2002) issued June 5, 2002, the United States Court of Appeals for the Federal Circuit affirmed that CAS 406 and CAS 410.40(b)(1) are not inconsistent with FAR 31.205-41, Taxes; FAR 52.216-7, Allowable Cost and Payment; and FAR 31.201-5, Credits. At issue in the case was a refund of Virginia state income tax received by Hercules in 1992 for taxes that the Government reimbursed in 1987 under a cost reimbursable contract for the operation of the Radford Army Ammunition Plant.

Hercules challenged:

... the Court of Federal Claims' conclusion that the incorporated FAR "Taxes," "Credits," and "Allowable Cost and Payment" clauses do not conflict with CAS 406 because CAS 406 does not require that a tax refund be allocated as an independent indirect cost.

Hercules contended that:

... its contracts with the government are subject to the CAS, and that CAS 406 requires it to follow consistent historical cost accounting practices of accumulating state income tax refunds as part of the measurement of tax costs in the year in which such refunds were received.

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The government responded that:

... this is a matter of contract interpretation, that the incorporated FAR clauses, as interpreted in Grumman Aerospace Corp. v. United States, 587 F.2d 498 (Ct. Cl. 1978), clearly instruct that any refund of a tax that has been allowed as a contract cost must be credited or paid to the government utilizing the same factors by which the costs were originally determined to be reimbursable. ... its entitlement to a share of the 1987 Virginia tax refund is a contractual right that is not affected by any cost accounting practices being used by Hercules.

The Court agreed with the government:

... that the incorporated FAR clauses determine the outcome of this case and that there is no conflict between the incorporated FAR clauses and the CAS in this instance.

The Court considered the impact of its prior decision in the Boeing Supplemental Executive Retirement Plan (SERP) case on the issue of CAS taking precedence over FAR when there is a conflict, by stating that:

... although CAS 406 requires a contractor to be consistent in its assignment of adjustments to expense to particular years, it does not grant the contractor immunity from specific FAR provisions governing the treatment of particular cost-related items, such as tax refunds. In this regard, the general requirement of consistent treatment of adjustments to expense is quite different from the specific CAS requirement regarding the allocation and assignment of pension costs that was held to prevail over an inconsistent DAR provision in United States v. Boeing Co., 802 F.2d 1390 (Fed. Cir. 1986).

The Court also considered the impact of generally accepted accounting principles by stating that:

... reliance on how generally accepted accounting principles and sound accounting logic might treat a refund for accounting purposes, similar to Hercules' argument here, was misplaced because the contract language controlled.

The Court agreed with conclusion in Grumman Aerospace Corp. v. United States, 587 F.2d 498 (Ct. Cl. 1978) that:

... Grumman's 1968 franchise tax costs having been reduced by a subsequent refund contractually entitled the government to its proper share of that reduction computed on the basis of its 1968 reimbursement of such costs.

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The Court in Grumman concluded that:

[t]he principal requirement of the [FAR 52.216-7] “Allowable Cost and Payment” and [FAR 31.201-5] “Credits” clauses is to provide the government with a refund when a cost that has been reimbursed to a contractor is later reduced.

The Court found these clauses require that income tax refunds:

... be passed through to the government using the same apportionment factors that were used to determine the amount of the previously reimbursed cost.

The Court denied a petition for panel rehearing and for rehearing en banc on September 3, 2002 (U.S. App. Lexis 20088).

### Guidance

If the contractor receives a refund of previously reimbursed income tax, the auditor should determine the government’s share of the refund based on the government reimbursement of that expense in the year in which the cost was originally incurred.

For example, ABC Company claims \$1,000,000 in state income tax expense in the G&A pool in 2000. The Company receives a \$500,000 refund of its 2000 income tax in 2002. The government participations in the G&A allocation bases are:

Fiscal Year	<u>2000</u>	<u>2001</u>	<u>2002</u>
Percentage	65%	70%	55%

The percentages represent contracts containing FAR 52.216-7 - Allowable Cost and Payment contract clause. The government’s share of the refund is determined as follows:

Amount of Refund		Government Participation for 2000		Government Share of Refund
<u>\$500,000</u>	X	<u>65%</u>	=	<u>\$325,000</u>

If the Company accounts for the refund in the fiscal year received (2002), the government would receive \$275,000 (\$500,000 X 55%). The auditor must assure the remaining government share of \$50,000 (\$325,000 – 275,000) is provided to the government.

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**Concluding Remark**

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact John Shire, Program Manager, Accounting and Cost Principles Division, at (703) 767-3250 or DCAA-PAC@dcaa.mil.

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